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Reporting Transnational Business Operations

Report No. 780 THE CONFERENCE BOARD

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Conference Board Report No. 780 Printed In U.S.A.

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Prices: $ 5.00—Associate; $15.00—Non-Associate

For prices on orders for classroom use, contact the Information Service Division.

ISBN No.: 0-8237-0216-2

A-1105-13 A

Reporting Transnational Business Operations

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A Research Report from The Conference Board

Contents

Page

ABOUT THIS REPORT vi

FOREWORD ix

1. IMPORTANCE OF INTERNATIONAL OPERATIONS OF U.S. COMPANIES 1
   - Objectives of this Study 2
   - Profile of Companies Studied 3
   - Extent of International Operations of U.S. Companies 5

2. FEATURES OF FINANCIAL REPORTING IN THE MULTINATIONAL BUSINESS ENVIRONMENT 7
   - SEC Regulation of U.S. Corporations 7
   - Standards of the FASB and Other Rule-Making Agencies 8
     - Consolidation of Foreign Subsidiaries 9
     - Foreign Exchange 10
     - Segment Reporting 10
   - Rules for Translating Foreign Currency Financial Statements 11
   - The Problem of Inflation 12
   - Consolidation of Foreign Subsidiaries 13
   - The United Nations and the International Accounting Standards Committee 13
     - United Nations Study Group 14
     - International Accounting Standards Committee 16
   - Other Factors 17

3. INTERNATIONAL FINANCIAL REPORTING AS VIEWED BY USERS 18
Results of the Survey of Investment Analysts 19
Rating Scale 19
Comments on Items of Disclosure 19
Attitudes of Analysts Toward Corporate Financial Reporting 21
Present Situation and Long-Term Trend 21
Sources of Information 22
Outside Auditors 22
Two Critical Areas of Disclosure 23
Characteristics of Survey Respondents 25

4. DISCLOSURE PRACTICES OF MULTINATIONAL CORPORATIONS 27
Extent of Overall Disclosures in Corporate Reports 27
Results of Analyzing Corporate Reports 28
Reasons for Differences in Company Scores 30
Extent of Disclosure of Important Items of Information 31
Items Most Frequently Reported 32
Items Most Frequently Omitted 33
Comparison with Analysts' Values 33
Range of Values 38

5. CONCLUDING COMMENTS 40
Satisfying the Demand for Information 40
Obstacles to Meeting the Demand 41
Cost of Meeting Disclosure Demands 42

Tables

1. International Involvement of *Fortune* 500 Companies 4
2. International Transactions of U.S. Businesses 5
3. Weights and Ranks of Items Considered by Financial Analysts to be Important in Evaluation of Corporate Reporting and Disclosure 20
4. Mean Scores of Companies, by Industry Sector 31
5. Comparison of Financial Analysts' Weights and Item Scores, and Concentration of Scores at Maximum and Zero Values 36

Charts

1. Principal Activity of Respondents in Their Respective Firms 26
2. Type of Firm Respondent Is Associated With 26
3. Distribution of Scores of 218 Multinational Corporations in Reporting 40 Items of Information Concerning Foreign Operations 29

About This Report

An important objective of The Conference Board's research program is to contribute to improved financial reporting and disclosure by business enterprises. The Board believes that corporate managements generally wish to provide public information that is of maximum usefulness to actual or potential investors and to all who have an interest in business affairs. To do so, these managements need to know what types of financial disclosures are expected. The Board seeks to meet this need by reporting the results of this study to the preparers and auditors of multinational corporations' financial reports.

This study identifies those items of information concerning the foreign operations of *Fortune* 500 companies that are considered important by investment analysts. A survey of a group of these analysts resulted in identifying 40 items considered to be important in evaluating international operations. The three top-ranking items of disclosure according to the surveyed analysts are:

- Company objectives, plans and policies;
- Description of exceptional risks from operating outside of the United States;
- Dependence on a single foreign customer, or a small number of such customers, for a material part of the business.

As far as the overall quality of disclosure is concerned, a large number of analysts indicate that multinational companies in general have made significant improvements in their financial reporting in recent years, but these analysts also note that they are not yet fully satisfied with the completeness of financial reporting by these companies. This report describes those items of information about foreign operations that the analysts

consider to be adequately disclosed. And, it also identifies the matters that they would like to see improved.

The annual shareholders' reports and annual reports to the SEC on Form 10-K of 218 companies in the *Fortune* 500 group were analyzed with respect to the extent that they disclose the 40 items of information deemed important by the financial analysts. In general, the company reports show a high level of disclosure of matters that the analysts consider of secondary importance. However, for the most part, the companies do not do such a good job of reporting some items that the analysts think are more critical.

An important step in this study was to construct quantitative scores for individual companies showing the extent to which their published financial disclosures (shareholders' reports and 10-K's together) reveal the various items listed by the financial analysts. In general, the largest corporations, those most heavily involved in international operations, and the more profitable companies, have the highest scores. Some industries, too, showed a greater degree of disclosure than others.

Foreword

THE EXPANSION of major corporations into the international business arena has not been accomplished without cost to U.S. corporations, to their executives, and to their stockholders. Political turmoil, personal danger, official corruption, risks of expropriation, involved financial arrangements, and local tax customs are only a few of the conditions that confront business executives when they go overseas.

Despite the successful penetration by so many companies into the area of international operations, the financial reporting practices that have developed over a long period of years make little distinction, for the most part, between business that is conducted within our own national borders and that which is transacted in foreign countries. And yet, the two often are very different.

The Trustees and management of The Conference Board believe that the story of U.S. business involvement in foreign markets deserves to be better known than it presently is. Corporate financial reporting is one important means by which such understanding can be enhanced. Accordingly, the Board asked a group of prominent investment analysts to identify items of information about the foreign operations of U.S. business enterprises that they consider most important to full investor knowledge of international operations. These items were then compared with an analysis of recently published annual corporate reports (shareholders' reports and 10-K's) of *Fortune* 500 corporations that have significant foreign operations.

The purpose of this comparison is not to single out specific companies or industries for supposed deficiencies in their in-

ternational reporting. Rather, the intent is to make known to the managements of companies with international operations the expectations and needs of some of the most expert readers of corporate reports, as well as the ways many international firms seek to meet those needs. The Board hopes in this way to contribute toward improved financial reporting of international business operations.

The Board is grateful for the support of the corporate executives and investment analysts who took part in this project by answering a lengthy survey questionnaire and by granting interviews. The research was conducted and the report written by Dr. Francis A. Lees, chairman of the Economics Department of St. John's University, Jamaica, New York. Conference Board supervision was provided by Francis J. Walsh, Jr., Director of Special Financial Projects in the Management Research Division, Harold Stieglitz, Vice President.

KENNETH A. RANDALL
President

Chapter 1

Importance of International Operations of U.S. Companies

TO an increasing extent, the international operations of many American corporations exert a significant influence on their overall financial performance. U.S. multinational companies now produce and sell their products virtually all over the free world, and the overall success of these companies depends more and more on the success of their overseas activities. At the same time that U.S. companies have been penetrating foreign markets, they also have been subjected to a difficult new environment of floating foreign exchange rates, sudden upward shifts in energy costs, political turmoil, and restrictive measures adopted by foreign governments.

In general, U.S. companies have coped successfully with most international economic and business stresses. Much has been said and written about such problems as international currency dislocations, threats of foreign governmental expropriation of the property of U.S. businesses, and demands by foreign government officials for under-the-table commissions for securing business. Techniques for dealing with situations such as these have been well explored and reported.[1]

[1]A few examples are: Joseph LaPalombara and Stephen Blank, *Multinational Corporations in Comparative Perspective*. The Conference Board, Report No. 725, 1977; *The Multinational Corporation: Studies on U.S. Foreign Investment*, Volume 2, Miscellaneous Report 73-3, 1973; and James Greene and David Bauer, *Foreign Investment and Employment: An Examination of Foreign Investments to Make 58 Products Overseas*. The Conference Board, Report No. 656, 1975.

Much less attention has been paid, however, to the complexities of financial reporting by U.S. corporations that grow out of these companies' multinational business operations. The efforts of accounting standard-setting agencies in the United States have been concentrated largely on other problems. A possible reason for the relative neglect of international disclosure standards is that financial reporting practices in this country matured during an era when the U.S. economy was much more self-contained than it is at the present time. When international operations were a mere drop in the bucket compared with the size of a company's domestic business, there was little pressure from investors or regulators for much specific disclosure of these overseas activities.

As this report will demonstrate, however, sophisticated members of the investment community (i.e., professional financial analysts) are keenly aware of the importance of international operations to the companies whose securities these analysts study. And they also recognize that there are wide variations among multinational companies concerning the quantity and nature of information divulged by these companies about their overseas activities.

These variations in international disclosure practices, which exist to some extent because the information needs of investors in this area have not so far been clearly identified, is the central problem of this research project.

Objectives of this Study

The growing contribution of U.S. multinational corporations to the level of business activity abroad and to the economies of host nations is something that deserves greater attention and understanding than it presently receives. But understanding requires facts; and facts about the scope of international business operations must necessarily come from the financial disclosures (primarily the stockholders' reports and 10-K's) of companies that engage in significant international activities.

One of the objectives of this study, therefore, is to analyze the published reports of major U.S. corporations with substantial international operations to show the variations in the reporting practices followed by these companies in disclosing their overseas operations. The results of this analysis are reported in Chapter 4.

A related objective is to present a tentative set of yardsticks by which the actual reporting practices of international business enterprises might be weighed. Identifying such criteria, however, is not

an easy task. The most promising starting point appears to be the following declaration by the Financial Accounting Standards Board: "Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions.... 'Investors' and 'creditors' are used broadly and include not only those who have or contemplate having a claim to enterprise resources but *also those who advise or represent them.*"[2] (italics supplied)

Following this line of reasoning, it appeared that a survey of a selected group of investment analysts would provide a catalog of expected items of financial information that would be helpful in evaluating corporate disclosures of international operations. Accordingly, such a survey was conducted as a principal element in this study. The results are reported in Chapter 3.

Profile of Companies Studied

Large U.S. corporations—those in the *Fortune* 500 class—were chosen as the group of companies whose international disclosure practices were to be studied. These firms were selected because: (1) They are publicly owned and their published financial disclosures (reports to stockholders and 10-K's) are likely to illustrate the best prevailing reporting practices as far as international operations are concerned. Another advantage of these companies is the ready availability of up-to-date information. (2) Many of the *Fortune* 500 companies are deeply involved in foreign operations and both the volume of their international business and the size of their overseas investments are significant.

Based upon a review of the annual reports of the *Fortune* 500 companies, 474 firms were identified as having sufficient foreign operations to justify initial inclusion in this project. As Table 1 shows, the extent of their international involvement ranges from 4 percent of the group that can truly be classified as "multinational"—50 percent or more of their business involvement is outside of the United States—to 173 firms (35 percent of the group) with less than 10 percent of their business overseas. Eleven of the *Fortune* 500 companies (2 percent of the total) are separately

[2] "Objectives of Financial Reporting by Business Enterprises," Statement of Financial Accounting Concepts No. 1, November, 1978. Copyright © by the Financial Accounting Standards Board, High Ridge Park, Stamford, Connecticut, 06905, U.S.A. Reprinted with permission. Copies of the complete document are available from the FASB.

Table 1: International Involvement of Fortune 500 Companies

Category	Description	1977-1979 Number of Companies	1977-1979 Percent of Total	1965 Number of Companies	1965 Percent of Total
A. Multinational	Companies with over 50 percent of sales, earnings, assets, employment or production outside the United States	19	4%	11	2%
B. Internationally Oriented	Companies with 25 to 50 percent of sales, earnings, assets, employment or production outside the United States	153	31	71	14
C. Firms with Significant Foreign Operations	Companies with 10 to 25 percent of sales, earnings, assets, employment or production outside the United States	129	26	129	26
D. Firms with Small Foreign Operations	Companies with less than 10 percent of sales, earnings, assets, employment or production outside the United States	173	35	284	57
E. Foreign Owned Corporations	Firms with a foreign parent company	11	2	5	1
F. Subsidiary of U.S. Company	Firms with a domestic parent company	7	1	—	—
G. Cooperative	Firms organized as a cooperative	8	2	—	—
Totals		500	100%	500	100%

classified because they are owned by a foreign parent. Two hundred and eighteen companies were eventually selected for detailed analysis of their disclosure practices.

To illustrate how the international business of large U.S. corporations has grown in a relatively short time, Table 1 compares the data gathered for the current project with an analysis of the international commitments of the *Fortune* 500 group of companies using 1965 data.[3] As a group, the *Fortune* 500 now report a much higher percentage of international operations than they did in 1965. And there is now a much greater degree of disclosure of these overseas activities than there was in the earlier study.

[3]Nicholas K. Bruck and Francis A. Lees, "Foreign Investment, Capital Controls, and the Balance of Payments," *The Bulletin, Institute of Finance*, New York University, April, 1968, pp. 16-17, 83.

Extent of International Operations of U.S. Companies

Since World War II, U.S. companies have been participating to an increasing extent in the economic and industrial expansion of the global economy and, in fact, have been making important contributions to this expansionary process. Large U.S. companies now depend on their international activities for a major share of their sales, earnings and market growth. An overview of this growing international involvement is shown in Table 2, which provides data on foreign trade and foreign investment activities of U.S. companies.

Insofar as foreign trade transactions are concerned, U.S. merchandise exports and imports more than doubled in the period 1971-1978 (lines 1 and 2, Table 2). Merchandise exports and imports in 1978 represented 6.6 percent and 7.0 percent of Gross National Product, respectively. In 1978, U.S. direct investment abroad was in

Table 2: International Transactions of U.S. Business (in billion of dollars)

Type of Transaction	Year 1971	1973	1975	1976	1977	1978
Merchandise export[1] . . .	$ 41.7	$ 71.4	$107.1	$114.7	$120.5	$141.8
Merchandise import	45.5	70.5	98.0	123.9	151.6	176.1
U.S. direct investment abroad[2]	10.9	11.1	14.2	11.6	12.9	16.7
Accumulated direct investment abroad . . .	83.0	103.7	124.2	136.4	149.8	168.1
Income on U.S. investment abroad[3] . . .	9.8	13.5	17.3	21.4	23.6	29.5
Capital expenditure abroad by majority-owned foreign affiliates	14.8	20.5	26.8	24.7	27.5	30.6
Sales of direct investment affiliates . .	$184.4	$291.4	$463.1	$514.7	a	a

[1]Excludes military exports

[2]Includes reinvested earnings of incorporated affiliates

[3]Consists of interest, dividends and branch earnings. Excludes reinvested earnings of foreign affiliates.

[a]Not available.

Source: U.S. Department of Commerce, *Survey of Current Business*, March, 1978, p. 32; June, 1979, p. 34; August, 1979, p. 56; September, 1979, p. 20.

excess of $16 billion. This series indicates that part of overseas expansion of U.S. corporations financed by American source funds and reinvested earnings. In addition, a large part of overseas expansion of U.S. companies is financed by offshore funds obtained in local money markets and in the Eurocurrency and Eurobond markets.

In 1978, the accumulation of direct investment abroad by U.S. companies exceeded $168 billion (line 4), and the income on U.S. investments abroad was in excess of $29 billion (line 5). Capital expenditures abroad by majority-owned affiliates of U.S. companies were estimated at over $30 billion in 1978 (line 6). Finally, it should be noted that sales of U.S. direct investment affiliates overseas were reported at nearly $515 billion in 1976.[4] The overseas production and sales of U.S. corporate affiliates is the third largest "economic bloc" in the global economy—outdistanced only by the production and sales of the United States and Soviet economies.

There are various reasons for the multinationalization of American business. Some U.S. companies have found that it has been necessary to develop local production facilities in the countries served in order to retain export markets. In other cases American firms are prompted to produce overseas to develop new market opportunities. In still other cases, the development of foreign operations has helped to achieve balance-of-payments benefits for the United States. But, whatever may be the underlying reasons, international operations represent a large and growing segment of business for many U.S. corporations, especially for those in the *Fortune* 500 category.

Extensive analysis of the nature and extent of the penetration by U.S. corporations into multinational markets, and the reactions of other countries to this development, are beyond the scope of this study. Those readers who wish further information on these and related topics are urged to examine some of the many Conference Board publications in the international area.[5]

[4]These sales were broken down as follows: Sales in the local economy 65 percent of the total; sales (exports) to the United States 7 percent of the total; and sales (exports) to third-country markets 28 percent of the total. *Survey of Current Business*, March, 1978.

[5]See footnote[1], page 1.

Chapter 2

Features of Financial Reporting in the Multinational Business Environment

FINANCIAL REPORTING in the multinational business environment has several characteristics that provide part of the background for this project. These features are described in this chapter.

SEC Regulation of U.S. Corporations

The Securities Acts of 1933 and 1934 direct the Securities and Exchange Commission to protect the public from false and misleading information by requiring publicly owned corporations to disclose financial and other information in a manner accurately depicting the results of corporate activities. Under this legislation, Congress gave the SEC broad powers to establish accounting and reporting standards. In general, the SEC has permitted private accounting bodies, presently the Financial Accounting Standards Board (FASB), to take the initiative in formulating and refining principles and standards used in financial reporting and disclosure. This approach is reflected in the Commission's Accounting Series Release No. 150 (December 20, 1973) which notes that "... the Commission has historically looked to the standard-setting bodies designated by the profession to provide leadership in establishing and improving accounting principles. The determinations by these bodies have been regarded by the Commission, with minor exceptions, as being responsive to the needs of investors."

Despite this delegation, the SEC also pursues its own functions relative to financial reporting and disclosure. Moreover, the SEC has been more active since the release of ASR 150 in formulating revisions on disclosures and reporting standards. For example, in 1975 the SEC increased the content of quarterly reports and the amount of quarterly data provided in annual reports. This was a follow-up of its 1972 Release No. 9559, "Financial Reporting—Quarterly and Other Interim Reports of Operations." In this release the SEC urged greater diligence by respondents in preparing news releases on financial results.

The SEC has also issued releases in response to FASB standards or proposals. For example, in 1974 the FASB proposed that there be mandatory publication of financial statements adjusted for changes in the purchasing power of the dollar as measured by changes in the GNP Implicit Price Deflator. The SEC subsequently issued Accounting Series Release No. 190 in 1976. ASR 190 requires the disclosure of information on certain replacement costs in notes or a separate section of the financial statements included in 10-K filings. ASR No. 190 was withdrawn by the SEC late in 1979 after the Financial Accounting Standards Board issued its new pronouncement on financial reporting and changing prices.

In December, 1976, the FASB issued FASB Statement No. 14, "Financial Reporting for Segments of a Business Enterprise." In December, 1977, the SEC issued ASR 236, which revised its line-of-business reporting to conform generally to FASB 14. At the same time, the Commission devised a new integrated disclosure form, Form S-X, which incorporates segmented disclosures, as well as others that were common to more than one SEC reporting form.[1]

Standards of the FASB and Other Rule-Making Agencies

In the United States, the Securities and Exchange Commission shares responsibility with private-sector organizations for developing reporting standards and accounting principles. As already noted, the SEC has supported the private accounting agencies as the primary initiators of accounting standards and principles.

[1]The SEC initiated requirements in the area of segmented reporting prior to FASB 14. In 1969, companies registering with the SEC were required to provide line-of-business information. In 1970, this was extended to include all annual 10-K reports, and four years later to annual reports to stockholders.

Accounting standards and principles, referred to as "generally accepted accounting principles" (GAAP), have been promulgated by committees or boards appointed or sponsored by the American Institute of Certified Public Accountants (AICPA), such as the Committee on Accounting Procedure and the Accounting Principles Board.

At the present time, the Financial Accounting Standards Board (FASB) is the authoritative accounting rule-making body in the private sector. It is sponsored and supported not only by the AICPA but also by a group of other membership organizations that have an interest in financial reporting.[2] A summary of those accounting principles and standards currently in effect that are most concerned with reporting and disclosure of international operations follows. These rules deal primarily with consolidation of foreign subsidiaries, foreign exchange, and segment reporting.[3]

Consolidation of Foreign Subsidiaries

Alternative rules for the consolidation of earnings and assets of foreign subsidiaries are described in Accounting Research Bulletin No. 43, "Restatement and Revision of Accounting Research Bulletins," issued by the Committee on Accounting Procedure of the AICPA in 1953. Further revisions in 1959 in Accounting Research Bulletin No. 51, "Consolidated Financial Statements," indicated that consolidated results are relevant and necessary for adequate financial reporting.

In 1966, Accounting Principles Board Opinion No. 10 permitted the use of either the equity or cost method of accounting should full consolidation of a subsidiary not be considered appropriate. Then, in 1971, APB Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock," provided guidelines for application of the equity method. Briefly, the equity method of accounting for a parent company's investment in a subsidiary permits immediate recognition of the subsidiary's current net income in the

[2]Francis J. Walsh, Jr., *Identifying Accounting Principles.* The Conference Board, Report No. 762, 1979, gives a detailed description of the early development of accounting principles and the role of the FASB.

[3]Useful sources of information concerning applicability of accounting principles and standards in financial reporting and disclosure are: Martin A. Miller, *Comprehensive GAAP Guide.* N.Y.: Harcourt, Brace and Jovanovich, 1980; and Elwood L. Miller, *Accounting Problems of Multinational Enterprise.* Lexington, Ma: Lexington Books, 1979.

accounts of the parent. In contrast, the cost method recognizes net income of the subsidiary only to the extent that it is remitted to the parent in the form of a dividend.

Financial Accounting Standards Board Statement No. 13, "Accounting for Leases," requires that a subsidiary whose principal business is leasing property to its parent company should be consolidated, and rules that the equity method is unacceptable. Accounting for investments in marketable equity securities not reported by the equity method is contained in FASB Statement No. 12, "Accounting for Certain Marketable Securities," issued in December, 1975. APB Opinion No. 16, "Business Combinations," issued in August, 1970, sets forth the generally accepted accounting principles to be used where purchase or pooling methods are used to account for business combinations.

Foreign Exchange

Foreign operations recorded in a foreign currency must be restated in U.S. dollars. The major accounting principle applicable in this area is set forth in FASB Statement No. 8, "Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements," issued in October, 1975. FASB 8 was amended in December, 1977, by FASB 20, "Accounting for Forward Exchange Contracts." In cases where exchange gains or losses arising from the translation of foreign subsidiaries are not included in current U.S. taxable income, the need for deferred taxes should be determined by reference to Accounting Principles Board (APB) Opinion No. 23, "Accounting for Income Taxes—Investments in Common Stock Accounted for by the Equity Method."

Segment Reporting

In 1976, the FASB issued Statement No. 14, "Financial Reporting for Segments of a Business Enterprise." FASB 14 requires that financial statements contain segmented information concerning operations by markets or industries, foreign operations and export sales by geographic area, and by major customers. Almost a year later FASB 18, "Financial Reporting for Segments of a Business Enterprise—Interim Financial Statements," was issued. Reporting of segment information for foreign operations depends upon the number of geographic areas in which the reporting company conducts significant operations.

In December, 1978, FASB Statement No. 24 was issued. Titled "Reporting Segment Information in Financial Statements that are Presented in Another Enterprise's Financial Report," Statement No. 24 indicates the conditions or circumstances under which segmented information is not required. In December, 1977, the AICPA released "Statement on Auditing Standards No. 21, Segment Information," to guide independent auditors in examining financial statements that contain segment information.

Rules for Translating Foreign Currency Financial Statements

Financial statements of subsidiary companies that operate in foreign countries are, of course, denominated in the currency of the country where the subsidiary operates. In order to consolidate the accounts of such subsidiaries with their U.S. parent corporations, it is necessary to translate these foreign currency reports into U.S. dollars. In times of wide fluctuations in exchange rates, such as have existed in international financial markets for a number of years, it is a real problem to find suitable translation rules.

The quest for a comprehensive translation methodology has absorbed the energies of accountants and financial executives for a number of years. There are good reasons for frustrations in arriving at translation procedures: Basic conditions underlying foreign exchange translation differ. Translating accounts from an unstable to a stable currency (from Chilean escudos to German marks, for example) is not the same as translating accounts from a more stable currency to a less stable one (for example, from U.S. dollars to Argentine pesos). In addition, translations are undertaken for a variety of purposes. These purposes may include recording export-import transactions, translating subsidiary accounts for consolidation and financial reporting, and translating the accounts of an independent company for the convenience of foreign audiences.

Problems related to determination of appropriate financial accounting standards exist where alternative treatments are available, that is, in cases where professional accounting bodies or other authorities have not agreed upon or mandated the use of a single accounting standard. For example, prior to the issuance of FASB Statement No. 8 in 1975, corporate treasurers had the choice of using more than one translation method for purposes of consolidating foreign branch and subsidiary financial statements.[4]

[4]Vincent G. Massaro, *Transnational Money Management: Issues and Practices.* The Conference Board, Report No. 743, 1978.

Companies could adopt translation methods that suited their own particular needs and circumstances. With the issuance of FASB Statement No. 8, the Financial Accounting Standards Board mandated the use of only the temporal method.

Under this method, the current rate of exchange is applied to items recorded at present prices, or to be effected at future prices (e.g., cash, receivables, payables, short-term debt). Historic rates of exchange are used with items that were recorded at past prices, such as plant and equipment. Revenue and expense items are translated at the average exchange rate for the period.

Considerable controversy has developed around FASB Statement No. 8. Many business executives whose companies are heavily involved in international operations contend that they have been forced to engage in foreign-currency hedging activities. Such activities make no economic sense, but are undertaken merely to offset distortions in earnings that result from applying the translation rules prescribed by the FASB. In response to such criticisms, the FASB has been reconsidering its 1975 Statement and, at the time of this writing, a proposed amendment to Statement No. 8 is in preparation and is expected to be issued shortly.

The Problem of Inflation

Inflation is presently a global problem afflicting developed and less-developed countries alike. It is a problem beyond management's control, but one with which managers must learn to live. Management's need and ability to evaluate the effects of inflation on company performance and financial position require that accounting data appropriately reflect the effects of company operations.

In the past, U.S. accounting principles have been based on the assumption of stable price levels. Given the recent surge in inflation, significant distortions often creep into accounting measures of corporate performance. Under inflationary conditions there is the danger that a firm may not preserve sufficient resources to replace assets whose prices have risen. In addition, there can be inflated corporate profit tax liabilities arising from inventory valuation "paper" profits.

Financial reporting for the multinational company is made more difficult by different rates of inflation in various nations. For one thing, the specific assets of a subsidiary in a given country may be experiencing a range of inflation rates above or below the general inflation rate for that country. However, the rate of currency

(foreign exchange) rate adjustment vis-à-vis the dollar may be related more closely to the difference in general rates of inflation in both the subsidiary firm's nation and the United States. Second, each country may have adopted its own set of accounting rules. These accounting principles may not provide adjustments for inflation in the same ways. Finally, foreign-exchange translation methods that are generally employed ignore the effects of inflation in the process of consolidating financial statements.

Consolidation of Foreign Subsidiaries

Given the increasing scope of multinational operations, more U.S. companies are reporting to the financial community on the basis of consolidated statements that combine the results of domestic and foreign operations. Consolidated statements depict the results of operations as if the group of affiliated companies represented a single economic unit, irrespective of legal distinctions, country location of production and sales, and differences in country of incorporation.

In most respects, the principles of consolidating foreign accounts are similar to those employed in consolidating domestic corporate units. U.S. companies generally exclude subsidiaries from consolidation where the U.S. parent finds itself limited in its ability to control the financial policies of the foreign unit, or where business activities are so dissimilar that combined financial statements would be meaningless.

In situations where a U.S. company elects *not* to consolidate the accounts of foreign subsidiaries, these investments may be accounted for either by the cost method or by the equity method. Under the cost method an investment in the shares of a foreign affiliate is recorded at cost, and income is subsequently recognized only to the extent that dividends are received. Under the equity method, the asset value of the parent's investment in the subsidiary is periodically adjusted to reflect the parent company's proportionate share of current profits or losses. Dividends received are treated as a reduction in the carrying value of the parent's investment.

The United Nations and the International Accounting Standards Committee

Two important new elements in the multinational financial reporting environment are the United Nations Study Group and the

International Accounting Standards Committee. Their origins and operations are described in this section.

United Nations Study Group

Much work has been carried on within the United Nations toward the formulation of international standards of accounting and reporting. The origins of this effort date back to July, 1972, when the UN Economic and Social Council (ECOSOC) requested the Secretary-General to appoint a Group of Eminent Persons to study the role of transnational corporations and their impact on the economic development process. As a result, in 1973-1974, the Group of Eminent Persons held a series of meetings resulting in a report, "The Impact of Multinational Corporations on Development and on International Relations." This report recommended the creation of a permanent commission and research center within the UN Secretariat. As a result of these recommendations, the Commission on Transnational Corporations was established on a permanent basis, and the Centre on Transnational Corporations began operating in November, 1975.

The Commission meets annually and serves as the central forum in the UN for the consideration of issues relating to transnational corporations.[5] Moreover, the Commission undertakes work that may assist ECOSOC in considering intergovernmental agreement on the activities of transnational corporations, and establishes priorities for work to be carried out at the Centre. The Centre carries out technical, policy analysis, and information analysis projects.

To aid in the understanding of the role of transnational corporations in economic development, the Centre initiated a study aimed at setting international standards of accounting and reporting for transnational companies. The first session of the Ad Hoc Group of Experts on the Establishment of International Standards of Accounting and Reporting took place in August-September 1976. Three technical papers were prepared to assist the Group in its initial efforts.[6] The study Group held a second series of meetings in July

[5]Robert Black, Stephen Blank, and Elizabeth C. Hanson, *Multinationals in Contention*. The Conference Board, Report No. 749, 1978, Chapter 10.

[6]These were subsequently published by the Centre on Transnational Corporations as *International Standards of Accounting and Reporting for Transnational Corporations, United Nations*, 1977.

1977, and issued a report of its findings later that year.[7] This report identified a list of the minimum items of financial and non-financial information to be disclosed in general-purpose reports by transnational corporations. (These are appended to the UN report in a 35-page annex.) The detail called for in the UN list of minimum items of disclosure is extensive and goes well beyond what any multinational corporation is currently publishing in its annual reports and SEC filings.

The International Chamber of Commerce responded to the United Nations report in a lengthy document issued by its Paris office.[8] The ICC took exception to the UN report by noting that it discriminates between transnational and national companies; that the heavy cost of collection and dissemination of information has to be weighed against the anticipated benefits; and that disclosure of certain types of information has sensitive implications for competition.

The implications of the UN recommendations can be quite serious for multinational corporations with far-flung operations extending into developing nations. The UN Study Group appears intent on establishing accounting and disclosure requirements that will eventually become mandatory; that will be applied on a uniform basis to all companies irrespective of the special nature of their activities; and that will require disclosure of accounting policies used in many areas of financial reporting. These disclosures include elimination of intra-group profits; explanation of methods of accounting for investments in associated companies; segmentation of data by geographical areas, including transfers between operating units and the basis of accounting for transfers between lines of business; accounting details regarding individual member companies of the multinational group; and nonfinancial information (e.g. description of degree of centralization for decision making; description of labor relations policies in each country; employee costs; average capacity utilization; description of main new investment projects, including their cost and effect on productive capacity).

Much of the information listed in the United Nations report is sensitive in one respect or another. Competitive practices and

[7]United Nations, *International Standards of Accounting and Reporting for Transnational Corporations*, 1977.

[8]International Chamber of Commerce, *ICC Commission on Multinational Enterprises*. Paris, April 24, 1978.

position may be revealed. Moreover, sensitive governmental relations may be affected by publication of some parts of the information the UN Group seeks to have disclosed.

The UN Group is still in the early stages of work in this area. Corporate executives of multinationals that would be affected by these mandated disclosures should follow the progress of the UN Study Group. In this way, they may be able to make their own improvements in international reporting and disclosure.

International Accounting Standards Committee

Organizations such as the FASB, AICPA, and SEC have been working toward standardization and uniformity of financial reporting and disclosure standards within the United States. Another organization, the International Accounting Standards Committee (IASC), has been working toward more uniform accounting standards in the international setting. Differences in accounting and reporting standards probably exhibit wider differences internationally than domestically, suggesting that the IASC has a more substantial task before it than its counterpart national organizations.

Considering the difficulties experienced in the United States alone in attempting to achieve greater uniformity in accounting standards, organization of the IASC in 1973 could be considered as a breakthrough. Professional accountancy bodies from nine countries became the founder members of IASC. Since its inception over 30 additional national professional accounting groups have been added as associate members.

The objectives of IASC are fairly clear. First, it is designed to establish and maintain an international committee whose function is to formulate and publish accounting standards that will gain worldwide acceptance. Second, members are to ensure that published financial statements comply with these standards, or that there be disclosure on the extent to which standards in use do not comply with IASC-endorsed standards. In this connection, auditors should satisfy themselves that the financial statements comply with IASC standards, or that audit reports indicate where noncompliance exists. Third, to secure general acceptance of IASC standards internationally.

The operating procedures of the IASC are not unlike those of the American-based Financial Accounting Standards Board, except that the FASB enjoys the luxury of full-time board members and a

substantial ongoing research program. Within the last five years the IASC has studied the following topics: accounting for leases; accounting for pension costs; accounting for diversified operations; and accounting for taxes on income. After a reasonable amount of study and discussion of a topic, the IASC releases an exposure draft.[9] After analysis and discussion, final international accounting standards are issued by IASC. Accounting standards already issued by IASC cover disclosure of accounting policies; valuation and presentation of inventories in the context of historical cost; consolidated financial statements; depreciation accounting; accounting responses to changing prices; and statement of changes in financial position.

The work of the IASC has been supported by a number of influential bodies. The World Federation of Stock Exchanges has bound member exchanges to require conformity with IASC standards with respect to listing requirements. The London Stock Exchange issued a statement indicating that it expects all listed companies to comply with IASC standards. In the United States, the AICPA affirmed its support of the work of IASC and issued a statement regarding implementation of its standards.

Other Factors

Multinational companies are often caught in the middle between host-country and home-government points of view with respect to their financial reporting (among other matters). In the past, the home-country point of view, in this case the United States, has been closely aligned with the need to protect investors; whereas the typical host-country's point of view has been oriented toward reporting the impact of corporate activities on the host-country's economy. Given these multiple objectives of reporting, it has been difficult thus far to achieve an international consensus on appropriate standards and criteria for international reporting.

The present study takes essentially a U.S. point of view, where a principal objective of financial reporting and disclosure is investor protection. For this reason, criteria used to analyze and evaluate company reporting were established by means of a survey of financial analysts.

[9]Exposure drafts have been issued by IASC on the following topics: accounting for research and development costs; accounting for foreign transactions; translation of foreign financial statements; treatment in the income statement of unusual items and changes in accounting estimates and accounting policies; and accounting for construction contracts.

Chapter 3

International Financial Reporting as Viewed by Users

NO RULE-MAKING AGENCY has established comprehensive standards concerning the information that should be disclosed by corporations about their international business operations. As indicated in Chapter 2, standard-setting agencies have issued statements concerning specific problems in some areas; the most notable in recent years being the Financial Accounting Standards Board's controversial ruling on translation of foreign currencies. But there are many more potential items of disclosure that have not received any attention from standard-setting agencies.

The lack of an authoritative set of disclosure standards in the international sector presented a formidable obstacle to the conduct of this research project. In order to analyze the actual disclosure practices of companies having substantial international operations, some list of potential items of disclosure, ranked in order of their relative importance, was needed for comparative purposes. The assembly of such a list was a major objective of this study. Existing literature on the issues of corporate financial disclosure[1] and the development of international accounting standards[2] provided initial

[1]S. Singhvi and H. Desai, "An Empirical Analysis of the Quality of Corporate Financial Disclosure." *The Accounting Review,* January, 1971; M. Edgar Barrett, "Financial Reporting Practices: Disclosure and Comprehensiveness in an International Setting," *Journal of Accounting Research,* Spring, 1976.

[2]See F. Choi and G. Mueller, *An Introduction to Multinational Accounting.* Englewood Cliffs, N.J.: Prentice Hall, 1978, Chap. 10; and J. P. Cummings and M. N. Chetkovich, "World Accounting Enters A New Era," *The Journal of Accounting,* April 1978; Wallace E. Olson, "Financial Reporting - Fact or Fiction?" *The Journal of Accountancy,* July, 1977.

insight into the nature and scope of matters that could potentially be disclosed in multinational corporations' financial statements.

Financial analysts are important users of information disclosed by multinational corporations. Information relating to international operations is used by these analysts in their reports and forecasts of corporate financial performance and in their recommendations to investors. Because of their dependence on published corporate information and their familiarity with financial reporting, a group of investment analysts was considered to be an excellent source of ideas concerning the items that should be disclosed about international operations of publicly held corporations.

Accordingly, a detailed questionnaire was prepared and mailed to a group of financial analysts, principally in the New York City area. This questionnaire focused on 10 categories of data having to do with matters such as sources of information, items of disclosure sought or expected (including nonfinancial information), and characteristics of the respondents and their firms. A total of 75 usable replies was received.

Results of the Survey of Investment Analysts

The survey of financial analysts resulted in the identification of 40 items considered to be important in the investment evaluation of both international and domestic operations of large- and medium-sized corporations. These 40 items are identified in Table 3. The same table indicates the weight of each item, which is based on the importance assigned to each item by financial analysts. Items are ranked in Table 3 in descending order, based upon their weights.

Rating Scale

In the case of each item of disclosure, respondents were asked to indicate, subjectively, the degree of importance of that item in their overall evaluation of a corporation's performance. A rating scale of 4 - 0 was used, and an averaged weight was calculated for each item. The mean weights of each of the 40 items were tabulated and deflated by the aggregate of the mean weights to arrive at a weight aggregate of 100. Using this scheme, the maximum "perfect score" for any one company would be 100.

Comments on Items of Disclosure

The first five items found in Table 3 were weighted, in descending order, between 3.03 and 2.88. These items cover a range of possible

Table 3: Weights and Ranks of Items Considered by Financial Analysts to be Important in Evaluation of Corporate Reporting and Disclosure

Rank	Item	Weight
1	Company objectives, plans and policies	3.03
2	Description of exceptional risks from operating outside United States	3.02
3	Whether material part of business depends on single customer or a few customers	2.96
4	Factors affecting next year's worldwide profitability	2.93
5	Foreign currency exposure in overseas subsidiaries	2.88
6	Major product lines produced and sold	2.87
7	Amount of foreign currency translation gains or losses	2.82
8	Line-of-business sales by product and country whenever 10% concentrations exist	2.81
9	Consolidation of majority-owned foreign subsidiaries	2.80
10	Taxation of foreign source earnings, U.S. taxes payable, use of foreign tax credits	2.77
11	Percent of foreign operations to total operations	2.76
12	Inventory accounting methods, percent foreign inventories	2.71
13	Historical summary and description of company operations	2.69
14	Brief description of nature of foreign currency uncertainties	2.64
15	Disclosure of data by geographic areas	2.63
16	Interim reports dealing with foreign currency gains and losses	2.57
17	Depreciation practices and methods for assets of foreign subsidiaries	2.56
18	Type of inventory valuation methods used in overseas subsidiaries	2.54
19	R and D expenditures, domestic and overseas	2.52
20	Policy followed for inclusion or exclusion of minority-owned foreign subsidiaries in consolidation	2.49
21	Financial statements for unconsolidated subsidiaries	2.45
22	Reporting of nonfinancial information relating to overseas activities and environment	2.43
23.5	Amount of foreign exchange forward contracts outstanding	2.39
23.5	Extent of offshore financing, changes in indebtedness of overseas subsidiaries	2.39
25	Foreign subsidiary earnings not remitted to U.S. parent	2.38
26	Basis of accounting for transactions between members of global group	2.37
27	Percentage of sales of domestic product to foreign affiliates	2.36
28	Forecast of next year's worldwide earnings and profitability	2.33
29	Relative importance of managed costs (R and D, maintenance, advertising)	2.31
30	Foreign source leasing income, foreign leasing expenses	2.28
31.5	Line-of-business sales by type of customer	2.27
31.5	Interim reports disclosing percent of foreign sales and earnings	2.27
33	Parent unconsolidated statements	2.25
34	Names, country of location, percent ownership of principal subsidiaries	2.21
35.5	Location and character of principal plants and productive facilities	2.18
35.5	Extent of intercompany sales and profits	2.18
37	Foreign ownership of company's equity shares	2.16
38	Replacement costs for assets located overseas	2.15
39	Extent of intercompany receivables and payables	1.99
40	Exchanges on which securities are listed for trading—overseas and United States	1.64

topics including company objectives, plans and policies, which financial analysts consider to be the single most important item of the 40 included in this analysis. A close second is the company's description of exceptional risks from operating outside the United States. Also ranking high are indications of material part of the business depending on a single (or a few) customer(s); factors af-

fecting next year's worldwide profitability; and foreign currency exposure in overseas subsidiaries.

The four items assigned the lowest weights (and ranks) by financial analysts include two items related to foreign ownership of equity shares (rank of 37) and exchanges in the United States and overseas where the company's securities are listed for trading. Also ranking low, according to the responses provided in the financial analysts' survey, was information concerning replacement costs for assets located overseas, and the extent of intercompany receivables and payables.

Attitudes of Analysts Toward Corporate Financial Reporting

In addition to identifying those items of disclosure that financial analysts consider important in evaluating the investment prospects of multinational corporations, the survey also sought to obtain an evaluation by these investment professionals on the reporting job that is presently being done by multinational corporations.

The specific areas where the respondents' reactions were sought included the degree of satisfaction or dissatisfaction with corporate reporting in general; whether or not improvements in reporting have been observed over a period of time; what sources of information are most valuable to the analysts; and what is expected from the outside auditor of a company's financial statements.

Present Situation and Long-Term Trend

The financial analysts were asked to comment on how satisfied they are with corporate reporting of international operations (see box). The weighted response was only 1.67 on a scale of 0 - 4, indicating that financial analysts are not particularly satisfied with financial reporting in general.

> As a professional in the financial field, how satisfied are you, in general, with corporate reporting of international operations? (circle one)
>
> Very satisfied — Not satisfied
>
> 4 3 2 1 0

A second question asked respondents to indicate whether U.S. companies have or have not improved their reporting of international operations during the past five years. The tabulation below reports the responses:

Only some companies have made improvements	33
Most companies have made significant improvements	30
There has been little or no change in this area	8
The quality of international reporting has generally deteriorated	0
Total	71

Sources of Information

Information used by financial analysts comes from a variety of sources. In the survey, financial analysts were asked to indicate the importance of various sources of financial information again on a scale of 4 (most important) to 0 (least important). The weighted responses are summarized as follows:

10-K Reports	266
Annual reports to shareholders	255
Interviews with company officers	241
Interim (quarterly) reports to shareholders	224
Analyses of company supplied by other investment advisers and researchers	179
Special press releases and other company publications	169
Industry and trade association releases	162
Other	29
	1,525

Sources of information indicated by financial analysts under the "other" category include management presentations, interviews with competitors and customers, news media reports, articles in financial journals, stock price action, and SEC filings.

Outside Auditors

Another set of questions in the survey focused on the role of the independent auditor. The first question asked respondents to indicate the most important functions of the independent auditor in

reviewing and attesting to the financial report of the multinational company. Respondents were asked to assign the most important function a weighted value of 3, the second most important function a weighted value of 2, and the third most important function a weighted value of 1. The tabulation below summarizes the results:

Function	Weighted Responses
Insure there has been conformity with accounting standards	131
Determine whether management has fulfilled its financial reporting obligation properly	120
Improve financial reporting and disclosure	68
Detect fraud	53
Improve on manner of presenting financial data	27
Insure timeliness of information	19
Exert surveillance over management	15
	433

It is noteworthy that the item assigned the highest importance, "to insure conformity with accounting standards," focuses on accounting standards rather than nonaccounting factors such as managerial performance, detection of fraud, presentation of data, and insuring timeliness of information. This result is in agreement with the overall response to the second question, which asked if the respondent feels the auditor has any significant influence on the adequacy of financial reporting and disclosure of international operations. Here the responses could range between a "definitely yes" (scaled a value of 4) to "definitely no" (scaled a value of 0). The average weighted response was 2.31, indicating that on balance, respondents tend to feel that the auditor does have a significant influence on the adequacy of reporting.

Two Critical Areas of Disclosure

One area of disclosure that has aroused considerable interest in recent years is the reporting of foreign exchange gains and losses. This follows from the volatility experienced in recent years in foreign exchange markets and the issuance of Statement No. 8 by the Financial Accounting Standards Board. Financial analysts generally

assigned high importance to items in the survey which dealt with foreign currency exposure and translation. There was a question concerning the method of recognition of translation gains and losses (see box).

It should be noted that financial analysts favor treating translation gains and losses as an adjustment to owners equity, rather than reporting them as gains or losses in the income statement as required under FASB-8. This opinion tends to support the findings of a recent Conference Board survey of corporate financial executives who express dissatisfaction with the requirements of FASB-8.[3]

Please respond to the following by checking yes or no.

	Yes	No	Total
a. Translation gains and losses should be recognized in consolidated income in the current reporting period.	32	35	67
b. Translation gains and losses should be included as an adjustment to owners' equity at end of that reporting period.	48	18	66

Another area of financial reporting and disclosure that has received increased attention in recent years is that of inflation accounting. Replacement costs for assets located overseas was ranked 38th in importance by responses from financial analysts (see Table 5). A supplemental question was included in the questionnaires addressed to the financial analysts, asking them to comment on the desirability of additional reporting in this area. For the question and the tabulation of responses see the box below.

Clearly, the responses favor additional elaboration and detail in reporting the replacement cost impact on income, assets and depreciation. However, there is an apparent inconsistency. The responses of financial analysts ranked inflation accounting via replacement cost third lowest among the forty items evaluated,

[3]Massaro, 1978.

In 1976, the Securities and Exchange Commission issued Accounting Series Release 190 requiring that large companies disclose the current replacement cost of inventories and productive capacity. Do you believe that reporting of replacement value for inventories and fixed assets should in addition include: (check one)

	Yes	No	Total
(1) the potential impact on aggregate income of applying current replacement cost?	44	25	69
(2) the potential impact on reported assets from applying current replacement cost?	43	26	69
(3) the potential impact on depreciation from applying current replacement cost?	50	17	67

indicating relatively low importance. Nevertheless, the responses indicated a strong desire to have additional information reported regarding the specific impact of replacement cost accounting on income, assets and depreciation. With the issuance of Statement No. 33, "Financial Reporting and Changing Prices," by the FASB in late 1979 and the subsequent phasing out by the SEC of Accounting Series Release No. 190, most of the desired additional information will now be reported by major corporations.

Characteristics of Survey Respondents

Most respondents to the survey are actively involved in analysis of common stocks and/or portfolio management. Most are employed by securities firms or by investment advisory services.

Two items in the questionnaire mailed to financial analysts provide information concerning the principal activities of the respondents in their respective firms, as well as the type of firms with which the respondents are associated. The principal activity of 33 of the respondents is analysis of common stocks (Chart 1). Second in importance is portfolio management (23 respondents).[4] Over one-

[4]Other activities of respondents included: group head of all functions, chief executive in brokerage firm, director of institutional research and sales, valuation of common stock and other corporate securities, and analysis of creditworthiness of corporate borrowers.

third of the cooperators are associated with securities firms (25 respondents). Chart 2 shows the types of firms employing the total group.[5]

Chart 1: Principal Activity of Respondents in Their Respective Firms

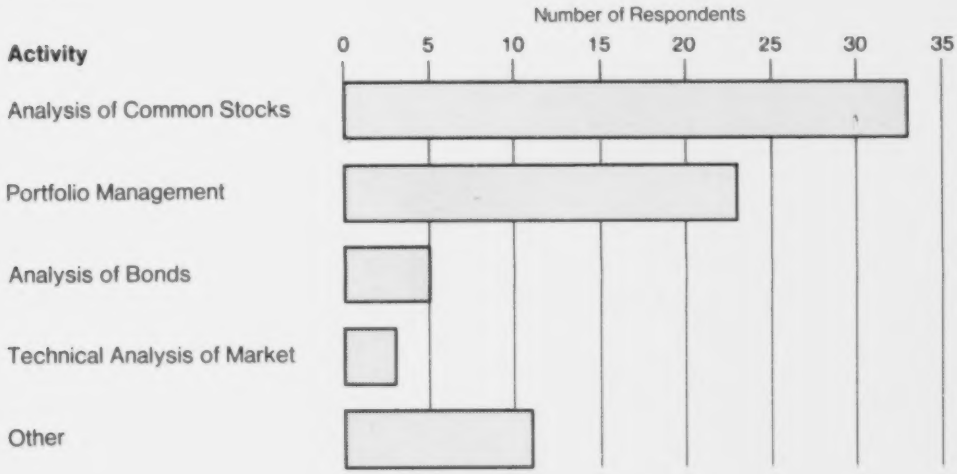
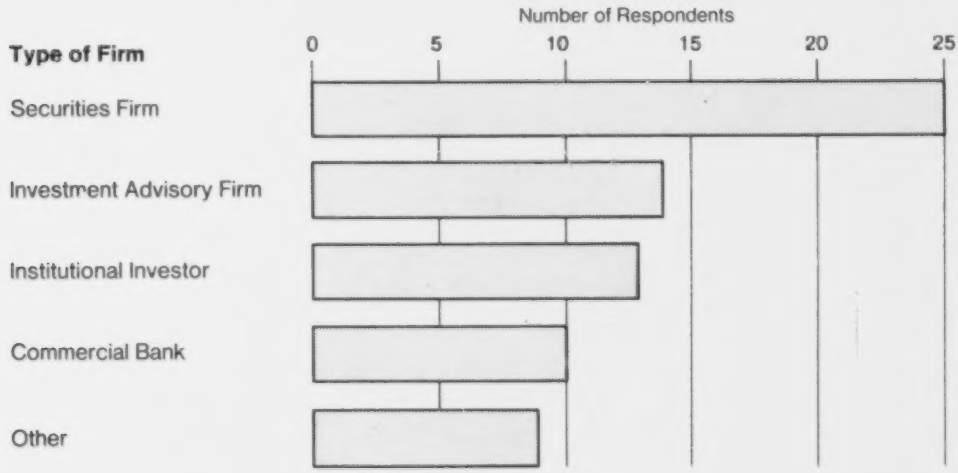


Chart 2: Type of Firm Respondent Is Associated With



"Other" firms that respondents are associated with include: a consulting firm specializing in valuation and financial studies, an accounting firm, investment company adviser, an energy corporation, and a manufacturing corporation.

Chapter 4

Disclosure Practices of Multinational Corporations

A MAJOR OBJECTIVE of this project is to study the actual disclosure practices of major U.S. corporations that have substantial international operations. Comparison of the prevailing practices of these corporations with the items of disclosure deemed important by the surveyed investment analysts reveals the extent to which multinational corporations are presently meeting the needs perceived by investors for information about foreign operations.

Two hundred and eighteen companies in the *Fortune* 500 category were chosen for analysis of their international disclosure practices. The disclosure media that were studied were the most recent annual stockholders' reports and 10-K reports to the SEC. Actually, 474 of the *Fortune* 500 companies were found to have at least some involvement with foreign operations. The 218 firms finally selected are those whose foreign activities have a significant effect on their overall performance.

Extent of Overall Disclosures in Corporate Reports

The companies whose annual reports and 10-K's were analyzed for this project are, on the average, complying with just about half of the financial analysts' wish list of information concerning the disclosures of companies' overseas activities. This section of the report describes the scoring system used to evaluate company financial reporting and disclosure as desired by analysts. It then summarizes these scores to give an indication of how the entire group of firms meets the analysts' expectations.

Tabulation of Fortune 500 Companies and Their International Involvement

As part of the analysis that was necessary to identify companies that have the most substantial commitments to overseas operations, a tabulation of significant foreign statistical data of the *Fortune* 500 companies was prepared. Based on published sources of information for 1978 operations, the tabulation presents the companies according to their *Fortune* rankings and reports the percentages of foreign operations that are included in total net sales, total net income, total assets, production, employment and miscellaneous data. The listing also indicates the 218 firms that were selected for further analysis in this project.

Associates who would like to have a copy of this supplement may obtain it at no charge by writing to The Conference Board, Inc., 845 Third Avenue, New York, New York 10022, Attention of Francis J. Walsh, Jr., Director, Special Financial Projects.

A subsequent section of this chapter shifts our emphasis to individual items of disclosure. It reveals the standard practices followed by the 218 firms studied in disclosing (or not disclosing) each specific item of information.

Results of Analyzing Corporate Reports

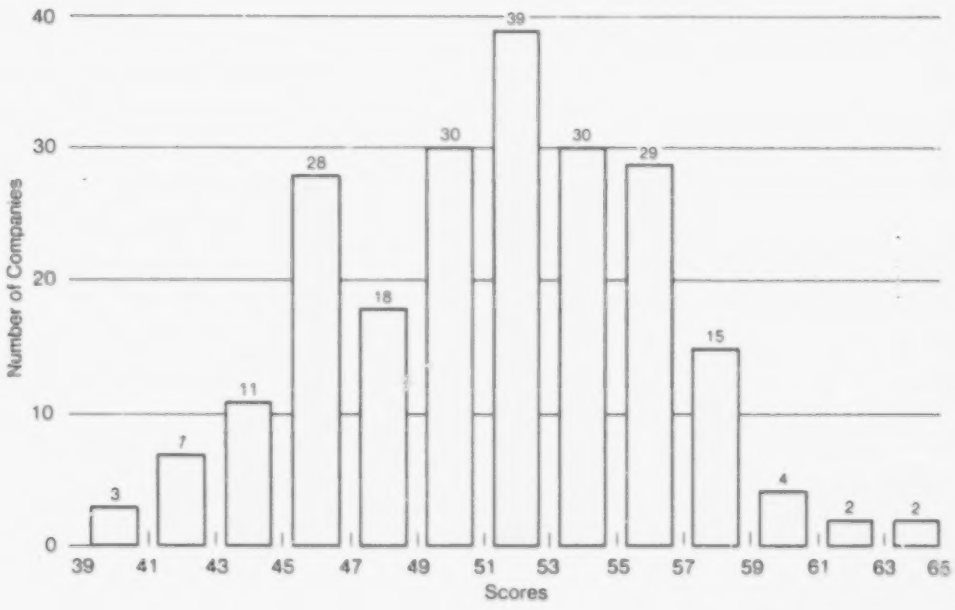
With such a large number of companies' annual reports to be analyzed, it was necessary to devise a scoring system where a numerical value could be assigned to each company's report. The scoring system was designed to show the extent to which a company's annual financial disclosures (shareholders' report and 10-K for calendar year 1978 or fiscal years ending in 1978) contained the 40 items of information deemed important by the surveyed financial analysts (see Chapter 3). The purpose of this scoring system is to show how the group of multinational corporations as a whole presently meets the perceived information needs of investors about foreign operations. The scoring system is based on a maximum-minimum basis of 100 to 0. In this regard the scoring system is necessarily arbitrary. To respect confidentiality, the scores assigned to individual firms' disclosures will not be reported in this publication.

The scoring system for each firm was quite simple. For each of the 40 items of disclosure described in the preceding chapter, a company presenting that item of information in a fairly complete manner received one point. Based on the analysis of the reviewer, a fractional point was assigned for a partial disclosure.

Because the 40 items vary in importance according to the financial analysts' ratings, the point score earned by a company for each item of disclosure was multiplied by the weight for that item as developed in the analysts' survey (see Table 3 on page 20). The products of this calculation for each of the 40 items were then totaled to produce the individual firm's score. The mean of the weights for all 40 items developed in the financial analysts' survey is 2.5; therefore, the maximum possible score for a company is 100. None of the companies in the analysis, of course, comes anywhere near this score. The highest score is 64.90 and the lowest is 39.74. The median score is 51.65. One hundred and eighty-nine of the 218 companies have scores concentrated in the range between 45 and 59. Chart 3 shows the concentrations of scores.

A comparison was made of the disclosure scores achieved by the 218 multinational corporations, based solely on the information

Chart 3: Distribution of Scores of 218 Multinational Corporations in Reporting 40 Items of Information Concerning Foreign Operations



contained in their annual shareholders' reports, with the additional data disclosed in their 10-K's. In general, the incremental information provided by the 10-K's was rather modest. Only eight of the forty items of disclosure were influenced by information obtained from 10-K's. And only one of these eight items was ranked high by the investment analysts: description of exceptional risks from operating outside of the United States. In this case, the contribution of 10-K information was substantial.

Finally, the company scores were tabulated on the basis of industry groupings. The results are presented in Table 4 which shows the mean scores of the various industry classifications. Only 209 of the 218 firms were included in this tabulation. The remaining 9 were omitted because they were the sole occupants of their SIC categories and, because of their size, their identities might have been revealed unintentionally. The table indicates that the industries with the highest disclosure scores are: rubber, plastic products; aerospace; chemicals; industrial and farm equipment. The lowest scoring sectors are: shipbuilding and transport equipment; and beverages.

Reasons for Differences in Company Scores

Further analysis of the individual reports, combined with interviews granted by corporate executives, lead to the following generalizations concerning the differences in scores among the companies:

(1) Larger corporations tended to attain higher scores than smaller companies principally because their greater visibility creates pressures for more complete reporting. Also, these companies' greater resources make the higher cost of additional financial disclosures less burdensome.

(2) Companies with more extensive overseas commitments tended to have higher disclosure scores. For one thing, these companies have more information to report. For another, investors in these firms would naturally have a greater interest in their foreign operations and, therefore, demand more information.

(3) Companies with higher rates of return on shareholders' equity and higher profit margins on sales scored higher than firms that are not so profitable.

If we compare company scores with their respective independent public accounting firms, there appears to be no significant

Table 4: Mean Scores of Companies, by Industry Sector

Code	SIC Industry Sector	Number of Companies	Mean Score
10	Mining, crude-oil production	5	50.5
20	Food	20	49.9
21	Tobacco	3	51.9
22	Textiles, vinyl flooring	2	48.4
23	Apparel	4	49.3
26	Paper, fiber, and wood products	6	51.0
28	Chemicals	23	53.4
29	Petroleum refining	11	52.3
30	Rubber, plastic products	6	53.5
32	Glass, concrete, abrasives, gypsum	6	51.8
33	Metal manufcturing	9	52.2
34	Metal products	10	48.7
36	Electronics, appliances	21	51.4
37	Shipbuilding, transport equipment	2	46.3
38	Measuring, scientific, photographic equipment	11	50.1
40	Motor vehicles	12	51.0
41	Aerospace	3	53.5
42	Pharmaceuticals	14	50.2
43	Soaps, cosmetics	4	50.2
44	Office equipment, computers	7	51.1
45	Industrial and farm equipment	24	53.3
47	Musical instruments, toys, sporting goods	3	51.3
49	Beverages	3	46.4
	Total	209	

relationship between the accounting firms and the scores of their clients.

Extent of Disclosure of Important Items of Information

The scoring system described above provides an indication of how close the multinational companies, as a group, come to disclosing the total package of information items that the financial analysts would like to see. This section of the report describes the extent to which each of the 40 individual items of desired information is either reported or not disclosed by multinational companies. And it also compares the items of information considered most critical by the analysts with the frequency of disclosure of those items.

Four different measurement approaches were used to gauge the

extent of disclosure of the 40 items of information. These four approaches are:

(1) Items most frequently reported
(2) Items most frequently omitted
(3) Comparison with financial analysts' values
(4) Range of values

Items Most Frequently Reported

Thirteen items of disclosure have a high concentration of company scores at the highest possible level (columns 7 and 8 of Table 5). These 13 items are disclosed in 90 percent or more of the company reports. As we can note in the tabulation below, 100 percent of companies fully disclose depreciation policies, 99 percent of companies provide a historical summary and description of operations, and 99 percent of companies fully disclose the percent of foreign operations. For the most part, the high percentage of companies reporting these items reflects financial reporting requirements and practices.

Percent of Companies	Item
100	Depreciation practices
99	Historical summary and description
99	Percent foreign operations
99	Inventory accounting methods; percent foreign inventories
98	Extent of offshore financing, change in indebtedness
98	Consolidation of majority-owned foreign subsidiaries
97	Disclosure of data by geographic areas
97	Replacement costs for assets located overseas
97	Major product lines
97	Exchanges on which securities listed, overseas and United States
96	Taxation of foreign source earnings, use of foreign tax credit
93	Names, country of operations, and percent ownership of foreign subsidiaries
90	Amount of foreign currency translation gains or losses.

Items Most Frequently Omitted

At the other end of the spectrum, eleven items of information are generally omitted from the financial reports of the multinational companies studied. Columns 9 and 10 of Table 5 show the types of information withheld by 90 percent or more of the companies (see tabulation below).

Percent of Companies	Item
100	Inventory valuation methods used in overseas subsidiaries
99	Foreign earnings not remitted to U.S. parent
99	Percent of sales of domestic product to foreign affiliates
99	Parent's unconsolidated statements
99	Extent of intercompany receivables and payables
97	Forecast of next year's worldwide earnings and profitability
97	Foreign ownership of company's stock
96	Amount of foreign exchange forward contracts outstanding
95	Description of foreign currency uncertainties
92	Foreign currency exposure in overseas subsidiaries
91	Financial statements of unconsolidated subsidiaries.

None of the companies discloses inventory valuation methods used in overseas subsidiaries; 99 percent of companies fail to disclose foreign earnings not remitted to the U.S. parent; and 99 percent of companies do not disclose the percentage of sales of domestic product sold to foreign affiliates.

Comparison with Analysts' Values

One of the most useful measurements of the degree to which multinational companies report information on their foreign operations is the score attained by these companies in revealing the items considered important by the surveyed financial analysts. Column 5 of Table 5 shows the average scores achieved on individual items of disclosure as a percentage of the weights assigned by the financial analysts.

Sixteen items of disclosure scored between 80.0 and 100.0 on this measurement scale, indicating that they are the items most highly valued by the financial analysts and are also most likely to be disclosed by multinational corporations (see tabulation).

Average Score for Item as Percent of Financial Analyst Weight	Item
100.0	Depreciation practices
99.6	Historical summary and description of company operations
99.4	Percent foreign operations
99.4	Inventory accounting methods, percent foreign inventories
98.4	Major product lines
98.3	Extent of offshore financing, change in indebtedness
98.2	Disclosure of data by geographic areas
98.1	Consolidation of majority owned foreign subsidiaries
97.4	Replacement costs for assets located overseas
97.2	Exchanges in which securities are listed, overseas and United States
96.8	Names, country of operations, and percent ownership of foreign subsidiaries
96.6	Taxation of foreign source earnings, use of foreign tax credit
88.2	Amount of foreign currency translation gains and losses
85.8	Research and development expenditures
84.4	Foreign leasing income, expenses
84.2	Location and character of principal plants and productive facilities

At the opposite end of the scale are 19 items of disclosure that scored below 40.0 according to this measurement scheme (column 5 of Table 5). These 19 items are the ones that financial analysts regard highly, but are least likely to find when working with

published disclosures of multinational corporations. They are listed below.

Average Score for Item as Percent of Financial Analyst Weight	Item
33.9	Factors which affect next year's worldwide profitability
33.5	Reporting of nonfinancial information
31.6	Whether material part of business depends on a single customer
24.8	Interim reports dealing with foreign currency gains and losses
19.9	Line of business sales where 10% concentrations exist
17.7	Interim reports disclosing percent foreign sales and earnings
12.8	Description of exceptional risks from operating outside United States
7.0	Line of business sales by type of customer
4.1	Financial statements of unconsolidated subsidiaries
3.4	Foreign currency exposure in overseas subsidiaries
1.9	Foreign ownership of company's common stock
1.8	Brief description of nature of foreign currency uncertainties
1.7	Amount of foreign exchange forward contracts outstanding
1.2	Forecasts of next year's worldwide earnings and profitability
0.7	Foreign earnings not remitted to U.S. parent
0.7	Extent of intercompany receivables and payables
0.6	Parent's unconsolidated statements
0.4	Percentage of sales of domestic products to foreign affiliates
0.0	Inventory valuation methods used in overseas subsidiaries.

Table 5: Comparison of Financial Analysts' Weights and Item Scores, and Concentration of Scores at Maximum and Zero Values

Item of Information	(1) Financial Analysts' Weight	(2) Rank of Weight	(3) Average Score for Companies	(4) Rank of Average Score
Company objectives, plans, and policies	3.03	1	1.89	15
Description of exceptional risks from operating outside U.S.	3.02	2	0.38	28
Whether material part of business depends on single customer	2.96	3	0.93	23
Factors which affect next year's worldwide profitability	2.93	1	0.99	22
Foreign currency exposure in overseas subsidiaries	2.88	5	0.09	31
Major product lines	2.87	6	2.82	1
Amount of foreign currency translation gains or losses	2.82	7	2.48	9
Line of business sales where 10 percent concentrations exist	2.81	8	0.56	26
Consolidation of majority owned foreign subsidiaries	2.80	9	2.74	2
Taxation of foreign source earnings, use of foreign tax credit	2.77	10	2.67	6
Percent foreign operations	2.76	11	2.74	3
Inventory accounting methods, percent foreign inventories	2.71	12	2.69	4
Historical summary and description of company operations	2.69	13	2.68	5
Brief description of nature of foreign currency uncertainties	2.64	14	0.04	32
Disclosure of data by geographic areas	2.63	15	2.58	7
Interim reports dealing with foreign currency gains and losses	2.57	16	0.63	25
Depreciation practices	2.56	17	2.56	8
Type inventory valuation methods used in overseas subsidiaries	2.54	18	0.00	40
R and D expenditures	2.52	19	2.16	11
Policy followed for inclusion and exclusion minority owned subsidiaries	2.49	20	1.75	17
Financial statements for unconsolidated subsidiaries	2.45	21	0.10	30
Reporting of nonfinancial information	2.43	22	0.81	24
Extent of offshore financing, change in indebtedness	2.39	23.5	2.35	10
Amount of foreign exchange forward contracts outstanding	2.39	23.5	0.04	34
Foreign earnings not remitted to U.S. parent	2.38	25	0.01	36

Table 5: Comparison of Financial Analysts' Weights and Item Scores, and Concentration of Scores at Maximum and Zero Values (continued)

(5) Average Score as Percent of Financial Analysts' Weight	(6) Highest Score Recorded	(7) Number of Firms With Highest Score	(8) Column 7 as Percent of Total Number of Companies	(9) Number of Firms With Zero Score	(10) Column 9 as Percent of Total Number of Companies	(11) Lowest Score Recorded
62.7%	3.03	41	19	1	—	0
12.8	3.02	3	1	157	72	0
31.6	2.96	69	31	145	67	0
33.9	2.93	4	2	21	10	0
3.4	2.88	3	1	201	92	0
98.4	2.87	212	97	—	0	.56
88.2	2.82	190	90	21	10	0
19.9	2.81	40	18	170	80	0
98.1	2.80	213	98	2	1	0
96.6	2.77	209	96	4	2	0
99.4	2.76	216	99	—	0	.54
99.4	2.71	216	99	1	—	0
99.6	2.69	215	99	—	0	1.34
1.8	2.11	1	—	207	95	0
98.2	2.63	212	97	2	1	0
24.8	2.57	54	24	159	73	0
100.0	2.56	218	100	—	0	—
0.0	—	—	0	218	100	0
85.8	2.52	183	84	32	15	0
70.4	2.49	149	68	62	29	0
4.1	2.45	11	5	199	91	0
33.5	2.43	5	2	50	23	0
98.3	2.39	213	98	3	1	0
1.7	2.39	1	—	210	96	0
0.7	2.38	1	—	215	99	0

Table 5: Comparison of Financial Analysts' Weights and Item Scores, and Concentration of Scores at Maximum and Zero Values (continued)

Item of Information	(1) Financial Analysts Weight	(2) Rank of Weight	(3) Average Score for Companies	(4) Rank of Average Score
Basis of accounting for transactions between members of global group	2.37	26	1.53	20
Percentage of sales of domestic product to foreign affiliates	2.36	27	0.01	39
Forecast of next year's worldwide earnings and profitability	2.33	28	0.02	35
Relative importance of managed costs	2.31	29	1.00	21
Foreign leasing income, expenses	2.28	30	1.92	14
Line of business sales by type customer	2.27	31.5	0.15	29
Interim reports disclosing percent foreign sales-earnings	2.27	31.5	0.40	27
Parent unconsolidated statements	2.25	33	0.01	38
Names, country of operations and percent ownership foreign subsidiaries	2.21	34	2.14	12
Extent of intercompany sales and profits	2.18	35.5	1.74	18
Location and character of principal plants and productive facilities	2.18	35.5	1.83	16
Foreign ownership of company's equity shares	2.16	37	0.04	33
Replacement costs for assets located overseas	2.15	38	2.09	13
Extent of intercompany receivables and payables	1.99	39	0.01	37
Exchanges on which securities listed for trading, overseas and U.S.	1.64	40	1.59	19

Range of Values

Finally, reporting can be evaluated on the basis of the range of values obtained in the process of assigning scores to individual firms' reports. The range of values indicates whether ratings for the group of companies for a particular item of disclosure are concentrated at the upper end of the range, lower end of the range, or spread across the entire range of possible company ratings.

Scores were concentrated in only 5 of the 40 items:

No. 6 Major product lines (high scores)

Table 5: Comparison of Financial Analysts' Weights and Item Scores, and Concentration of Scores at Maximum and Zero Values (continued)

(5) Average Score as Percent of Financial Analysts Weight	(6) Highest Score Recorded	(7) Number of Firms With Highest Score	(8) Column 7 as Percent of Total Number of Companies	(9) Number of Firms With Zero Score	(10) Column 9 as Percent of Total Number of Companies	(11) Lowest Score Recorded
64.6	2.37	141	65	70	32	0
0.4	2.36	1	—	217	99	0
1.2	2.33	1	—	211	97	0
43.5	2.31	15	7	15	7	0
84.4	2.28	182	83	33	15	0
7.0	2.27	7	3	193	89	0
17.7	2.27	24	11	149	69	0
0.6	2.25	1	—	216	99	0
96.8	2.21	202	93	1	—	0
79.8	2.18	175	80	42	19	0
84.2	2.18	145	66	6	3	0
1.9	2.16	3	1	211	97	0
97.4	2.15	212	97	5	2	0
0.7	1.99	1	—	215	99	0
97.2	1.64	212	97	6	3	0

11	Percent foreign operations	(high scores)
13	Historical summary	(high scores)
14	Description of foreign currency uncertainties	(low scores)
18	Inventory valuation methods of foreign subsidiaries	(low scores)

All other items were distributed throughout the range for the group of companies.

Chapter 5
Concluding Comments

THIS STUDY has considered several aspects of the disclosure of information on foreign operations that are of concern to investors and to those who prepare the financial reports of multinational corporations. The project has sought to identify those items of information that investors (financial analysts in this case) deem important. And the report has attempted to show the extent to which large, publicly held multinational corporations supply the information that is sought.

Satisfying the Demand for Information

In general, the financial analysts responding to the survey indicate that corporations with significant foreign operations show improvement over time in the degree to which their published reports meet analysts' needs for information. The investment analysts add, however, that there is still a gap between the amount of information sought and that which is actually provided.

The analysis of data in this report tends to support the survey respondents' assertions. As shown in Chapter 4, transnational corporations, on the average, publish just about half of the information perceived to be important by professional readers of financial statements.

This conclusion must be tempered, however, by the fact that financial analysts do not rely entirely on annual reports and 10-K's for their information. Members of the investment community have frequent contacts with executives of companies whose securities are

monitored by the analysts; and a great deal of information is transmitted by one-to-one contacts and in meetings between company executives and groups of analysts.

Some companies also distribute quantities of data in a form that supplements the disclosures made in their formal financial reports. Therefore, the analysts actually receive considerably more information about companies than is apparent at first glance; however, they may have to do some digging to find it.

Obstacles to Meeting the Demand

Some executives interviewed during the research phase of this project indicate that certain conditions prevail in the worldwide economy that may always prevent multinational corporations from satisfying demands for information as quickly as financial analysts and others would like.

Specifically, conditions that generate demands for information are constantly changing. New structural and economic relations impel companies constantly to phase out some activities and branch out into new ones, or they may significantly alter the way companies operate. For example, the abandonment of fixed exchange rates and the resulting increased volatility in foreign currency relationships exemplify new economic relationships that might call for additional detail in reporting currency effects. The proliferation of distinct product lines by companies, each affected by different market trends and conditions, may call for segment reporting. Changes in company operations and in economic conditions beget changes in the mix of information required for intelligent investor awareness, and understanding of profitability and earnings prospects. Most such events and situations eventually find their way into published disclosures of multinational companies, but there is usually a time lag.

Another obstacle to meeting the perceived demand for information is the complexity of the world of financial reporting. For example, several executives state that they would prefer to provide no information, rather than information that could be misleading, misinterpreted or confusing. In several cases companies have said they are caught between government agencies with divergent viewpoints on matters relating to disclosure. One government agency may mandate reporting of specific information, while another waits in the wings to act against the company should the reported information be subject to misinterpretation.

These executives, for example, cite their uneasiness over the possibility that the SEC might mandate the disclosure of internal forecasts of earnings. They anticipate lawsuits by investors who might suffer losses by relying on such forecasts if and when the forecasts prove to be incorrect. And companies that depend upon earnings generated in numerous volatile areas of the world are bound to make errors in such predictions.

Another example is the question of legality of certain foreign payments. Under the Foreign Corrupt Practices Act of 1977, the SEC shares enforcement with the Department of Justice. Some U.S. companies have complained that their ability to compete in foreign markets is reduced as a result of this law, and that as much as $1 billion a year is lost by American companies in foreign sales. The Justice Department has indicated a willingness to provide guidance to U.S. companies about the legality of specific foreign payments that are contemplated. However, the SEC's Enforcement Division has refused to adopt a similar guidance program or to be bound by Justice Department decisions.

Cost of Meeting Disclosure Demands

Executives of multinational corporations who were interviewed in connection with this project state that the cost of supplying financial information to investors, regulatory agencies, and other reporting constituencies is substantial. It is not possible to state conclusively just how much it costs multinational companies as a group to comply with external reporting requirements. Although many firms estimate these costs, and some have refined systems for collection of data on their financial reporting costs, it is not very practical to compare one company with another because of different practices in classifying cost elements.

Nevertheless, the interviewed executives supplied information that permitted a few generalizations. The cost components that generally go into their calculations of the cost of external financial reporting are:

Executive and financial staff time:

- Senior financial officers
- Divisional and subsidiary executives
- Treasury and controllership staff members
- Internal auditing staff

Computer services
Legal services
External auditing services
Printing and distributing reports

Executive and financial staff time is by far the most important element in the cost of external financial reporting. According to estimates supplied by the interviewed executives, more than 60 percent of the cost is concentrated in this component. At the other end of the spectrum is the cost of printing and distributing reports; only about 1 or 2 percent of the cost of reporting is accounted for by production and delivery of the end product. As might be expected, audit fees are the most substantial external cost incurred by companies in meeting investors' needs for information.

Financial executives point out that the cost of supplying information to the public is a limiting factor in satisfying the financial community's expectations for more information about foreign operations. Major corporations typically wish to disclose as much information as is practical to the financial community because they believe that, in the long run, this policy will result in optimizing the market value of their securities. Nevertheless, executives observe that the demands for more information can never be fully satisfied. And they wonder at what point the cost of attempting to comply exceeds the benefits derived from the information sought.

COVER BY VIRGIL KOCH